

DOW THEORY LETTERS INC.

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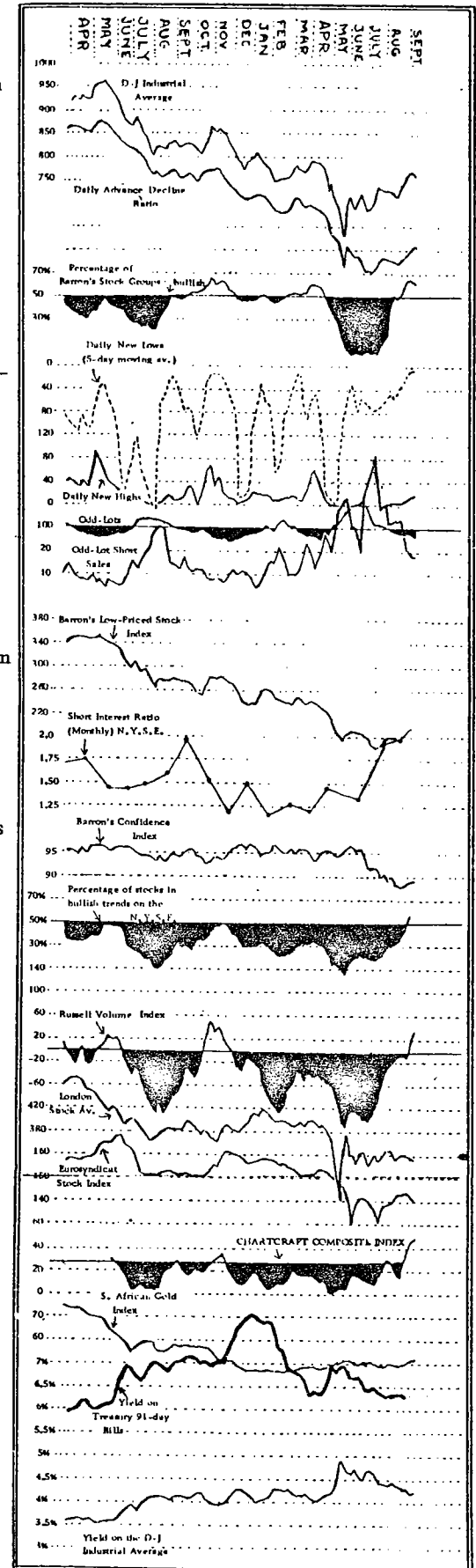
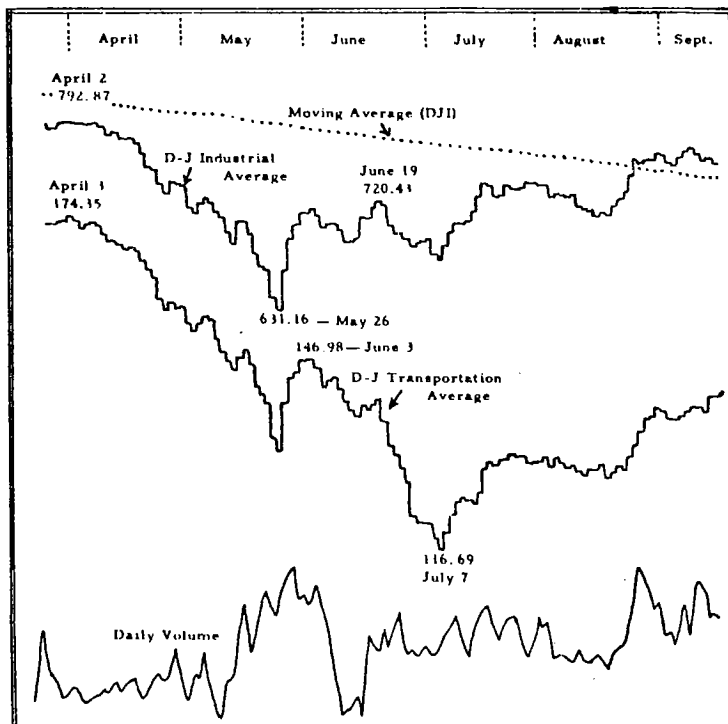
Letter 473

THE MARKET: Market students tend to pay far too much attention to the pattern of the Averages while ignoring the extremely important consideration of phases, duration of movements, yields, psychology. To my knowledge, every major bull and bear market since the turn of the century has undergone three fairly distinct psychological phases (the phases are discussed in a later section of this Letter). I firmly believe that before this bear market is over, it will complete its second and its third phase.

I have discussed the characteristics of a bear market's third phase many times in these reports, such characteristics as extremely low volume, great values (and high yields) on blue-chip stocks, a collapse in speculative activity, despondency on Wall Street with a general sentiment that "the market will never come back," and forced liquidation of the best (and therefore most marketable) issues. By my interpretations, it is clear that the current bear market has never entered anything like a classic third phase.

It is crucial to remember that the orthodox "bull signal" in the Averages is only valid when it occurs after a primary bear market has undergone true third phase characteristics. I have been asked repeatedly what it would mean if the Transportation Average betters its June 3 recovery peak of 146.98, therefore confirming the bullish structure of the Industrials. My answer is that a Transportation confirmation, coming as it would without any manifestations of a bear market third phase, would merely signify that the current secondary uptrend was to extend.

THE PICTURE: Most investors do not fully comprehend the nature of an upward correction in a primary bear market. As noted in the last Letter, the movements against the prevailing primary trend can look deceptively like the real thing. This applies to movements in the Averages and in individual stocks. Following



Page 2 the 1929 crash, many stocks which had been pulverized recovered amazingly in the ensuing 1930 correction.

A variety of stocks actually regained half to two-thirds of their losses. In fact, the motion picture stocks rose to new highs during early 1930. By 1932 the great 1930 rally was forgotten as many of the 1930 recovery favorites sank to unbelievable lows with a number going out of business entirely.

The May-August recovery looks deceptively good. It is occurring even while new clouds gather on the horizon. For instance, the U.S. dollar has weakened relative to some of the gold-backed currencies such as the mark, the French franc and the Swiss franc. The pound has dropped to about a one-year low as British business problems mount. Dollars continue to build up in Europe in the face of U.S. deficits and a drop-off in Eurodollar demand. The price of gold has pushed above \$36 an ounce, and gold stocks are flirting with their highs for the year. Vietnam continues as a fantastically expensive war with 400,000 G.I.'s still involved in this conflagration. Cambodia faces a possible Communist take-over. The Mid-East boils with airline hijackers entering the picture along with a breakoff by Israel of the fragile peace negotiations.

Meanwhile, in a barely-polite report, the IMF states that the worst U.S. inflation in twenty years is a threat to the free world. It places control of the rampant U.S. inflation at the top of the world economic priority list, and warns that the Nixon Administration is "behind schedule" (translation: doing little) in its "campaign" to check rising prices.

How can the market climb while monetary, social and political realities look increasingly poor? How can stocks rise when the foundation of the securities edifice, the bond market, faces a rendez-vous with an unpleasant destiny? The fact is that bear market corrections arrive when the market is oversold, regardless of what the future holds. Rallies have occurred weeks before some of the most disastrous events in history.

In his September 2 report, economist Eliot Janeway (who possesses a remarkably good track record) wrote: "Given that the good news about the stock market rally boils down to the underlying question about the bond market rally, the bond market rally is now on a collision course with the biggest spate of credit demand anyone has ever tried to measure or that it has even been called on to absorb. From September to December it will be running uphill into an irresistible barrage of sandbags, with corporate and government sandbaggers crowding and straining to hit it faster and harder with bigger new offerings."

Mr. Janeway knows (as every investor should know) that few stock market rallies can hold together in the face of a bond market in shambles. And the possibility of shambles is a very real one in the debt market of late 1970 and 1971. Every investor shuddered a few months ago as the Penn Central sank into bankruptcy. I wrote at the time that the Penn Central was just a preview of what lies ahead. Hundreds of corporations, many cities, municipalities, states and what-have-you are over their heads in debt. And just last week (see clip) the city of Newark, New Jersey faced the possibility that it was going to have to fail as a corporate entity.

To my mind, what we are seeing is a most callous and flagrant example of political expediency. I believe that the Nixon Administration utterly panicked toward the end of the 18-month plunge in the stock market. The panic turned into frenzy as Penn Central declared bankruptcy and as Lockheed teetered on insolvency. With elections coming up in the fall the word went out to open the floodgates of money and credit, and that's just what happened (see clip from Barron's). There's no question in my mind but that those floodgates will have to close just as violently either before or just after elections. Then with a whopping federal deficit looming, with inflation rocketing, with corporation profits still sluggish or receding, stocks, (still in the grip of a primary bear market) will be hit from all directions at once.

Now here is a very interesting face. Mr. Paul Dysart (Trendway Report) keeps an historical record of the plurality of advances over declines (and declines over advances) on days when volume declined below the previous day. He calls this his "Negative Volume Index" and notes that the direction of the negative index forecasts the sentiments of the informed minority (vs. the uninformed and emotional majority). In his report of September 4, Mr. Dysart writes: "This is the first bear market in history that has declined largely on negative volume..... This is direct contrast to all prior bear markets." I have noticed and written repeatedly about these same volume characteristics. All during 1968 to 1970 the market declined on lower volume, and rallies invariably bringing out the higher volume (as the public took heart and participated).

I interpret this important phenomenon as follows: so far we have seen the "polite" part of this primary bear market. This is the portion of the bear market in which stocks go down without setting off fears, without setting off infectious panic. But I

Bankruptcy Move Hinted For Newark

NEWARK, N.J. (UPI) — The City of Newark faces a \$60 million 1971 deficit, largest in its history, forcing at least one municipal adviser to suggest bankruptcy proceedings.

Unwilling to ask higher property taxes from its 378,000 residents, New Jersey's largest city is staking its survival on the state legislature, which it hopes will come to the rescue in the next few weeks.

"If there is no legislative action," said one city hall source, "then we're going to have a tremendous deficit."

WHAT we admire most about the Fed under its new management is the resolute way it has stuck to its guns. Undaunted by political pressure, heedless of the siren song of short-term economic gain, it is holding manfully to its avowed course of monetary gradualism, of prudent even-handedness. What better evidence of its stern resolve to avoid the extremes of policy and the taint of expediency than this intelligence from Salomon Brothers' August 29 "Comments on Credit": "For the past four weeks, the money supply has increased at a seasonally adjusted annual rate of 18%." Next stop, Brazil?

Alan Abelson, whose acid sense of humor is often the talk of the financial community, let go with this comment in his Sept. 7 (Barron's) column, "Up and Down Wall Street".

believe the next major phase of the bear market is going to be on expanding volume. Ultimately this primary bear market is going to conform to its predecessors in that there is going to be an area of panic-volume, broad liquidation, the crowd selling "because everybody else is selling". That should wind up the second psychological phase of the bear market. This should be followed by the final third phase, which, if it resembles the third phase of other bear markets, will be a long, deep, low-volume decline to "outlandish" depths, a decline which will arouse disbelief on the part of a demoralized investment community.

Last week I received a letter from a gentleman at a large New York Bank, and the letter raises an important question which deserves answering here. He writes: "I have been particularly interested in your comments to the effect that we now have seen two of the three major declines that mark a primary bear market. Referring to the chart on Page 4 of your Letter No. 469, two major slides are quite noticeable (one in 1966 and the other in 1969-70). However, there is a third slide (in late 1967 and early 1968) that is very clear in the Transportation Average but not so noticeable in the other two averages. From your letters, it is clear that you do not regard this as one of the three major phases of the primary bear market; however, I would like to hear some more of your reasoning as to why it does not qualify."

Now I believe this gentleman is expressing a common misconception, a misconception which stems from a confusion between Dow Theory and the Elliot Wave Theory. Let me attempt to clarify. Elliot (writing in the 1930's) believed that bull movements occurred in a five-step series of upward zig-zags, three rising waves and two declining wave-corrections. He believed that bear movements occurred in a three-step downward zig-zag, two declining waves separated by a single corrective rising wave.

The fact is that Elliot's observations regarding the wave theory have been born out so many times in actual practice that they must be taken seriously. The problem is that most amateurs do not know how to break the waves down correctly. Each Elliot wave may break down into many sub-waves, and a mere glance at a chart and a cursory dividing of a structure into three-wave and five-wave patterns is usually so far from a true Elliot analysis as to be more deceptive than useful.

Hamilton Bolton (founder of the Bank Credit Analyst) did some remarkable work on Elliot, and Bolton's research and interpretations have been carried on by the present editor, Donald Storey. Storey believes that the first wave of the current bear market started for the Dow Industrials in February, 1966. The first wave ended at the October, 1966 lows. The second wave (and this was the major corrective wave) carried to either the December, 1968 peak or possibly the May, 1969 peak. From there the third leg (which was again a downward leg) began, and Storey believes we are continuing in that leg now. He feels that this leg will ultimately approach or break the 1970 lows, going perhaps as low as the 1962 Dow low (535) or the 1956 and 1957 peaks (520).

So much for a smattering of Elliot interpretation. Now according to Dow Theory (which does not adhere to form as does Elliot) a bear market simply goes down in any number of primary (downward) legs separated by upward corrections. The bearish action (and corrections) may assume any structure, but most important, during all this the market undergoes three psychological phases or periods. The first is the erasing of the euphoria and frenzy of the previous bull market's final upward explosion. The second phase of a bear market (and any of these phases can be made of any number of price movements) is the phase wherein the market goes down in reflection of deteriorating economic, social and political considerations. The final phase is the liquidation phase, and here stocks may go down for no other reason than credit distress, the need to raise money, mass pessimism on the part of the public, and a last effort to wrest some cash from whatever stock holdings still remain in the hands of shareholders. This is the phase in which Robert Rhea warned, "Watch the blue chips." For the quality stocks in the third phase are sold because Wall Street still remains a cash market for the very best equities, while lesser-quality shares command little or no market at all. And cash is needed!

One last comment on this discussion. There seems to be massive resistance on the part of investors to accepting the three-phase psychological portion of the Dow Theory. After all, following two decades of relative optimism who is the Dow Theory to tell a man that "before this bear market is over abject pessimism and despair will reign"? Times are different, the Government is bigger, smarter, science has marched on, men have learned more. What is the Dow Theory, some sort of all-seeing threatening crystal ball? No, it isn't. It's simply a body of observations based on human psychology and market movements.

I well remember during the early 1950's wondering how that sluggish, low-volume, frustrating "pseudo-bull market" was ever going to produce a second phase, much less an exciting third phase. Third phase, were they kidding, no one knew how the Dow was even supposed to get above the formidable, crazy 381 peak of 1929 (hadn't it been looking at that high for over twenty years?)

Page 4 So that's it, people don't study history, they don't read and re-read the newspaper of the past, they just blindly (and pathetically) insist that history will never again repeat, and then they list their absurd reasons why. That's why the great Dow Theorist William Hamilton remarked, "We are a childish people. We like to be told what we want to believe." But Dow's Theory pays no attention to Presidential wishes, Congressional wishes, the public's wishes or anyone else's fantasies I hopes. It's a harsh theory during a major bear market and a wonderful theory during a major bull market. Unfortunately, now people believe its lessons during either phase.

FEAR: This is a rather unorthodox Letter, but I've started so I might as well continue. I have been vitally interested in psychology and the way people behave (myself definitely included) for the past twenty years. One of the aspects which has particularly fascinated me is fear. It is my own guess that about 90% of the average man's true fears are never, ever expressed. They are repressed, and they build up and reside within the psyche in the form of tension, anxiety and frustrations. Such tensions and anxieties, when they have no outlet at all, can assume the form of pain and even disease. Many people "act out" their fears, releasing some of the stored-up tension in a variety of ways such as compulsive drinking, working, smoking, fits of anger, sex, talking, stealing, etc. But acting out unexpressed fears will not get rid of these fears. Acting out can be likened to raising the escape-valve of a boiler for a few seconds. It merely keeps the boiler from exploding until the pressure mounts again.

I know that the average reader will tend to deny my thesis of ever-present fears. But think about it. You meet a new person and you don't say, "I feel anxious because I don't like the look on your face." You're at a restaurant and you don't say, "Hey waiter, you're giving me lousy service, but I'm afraid you'll get angry if I don't leave a tip." You break a shoe-lace on the street and bend over to fix it, but you don't say, "Gad, I'm scared I look a fool bending over to mess with my shoe." You have been taught since birth that you can only express certain "acceptable" thoughts, that society frowns on complete honesty, and you won't have a friend if you say what you really feel. The great majority of fearful (and unacceptable) thoughts are thoroughly repressed, and those repressions are stored up and build tension. The fear (and pain) forms a reservoir; it's locked in.

Now to get back to the stock market. The market is made by the minds of men. And since men's minds make the stock market, I believe that the dominant and by far greatest emotion in the market is fear. Sounds nasty doesn't it. But fear keeps men from buying at the bottom, it scares people out all the way through a bull market. Near the top fear of losing out on the party (we call this fear "greed") dominates, and consequently at the top the public pours in to purchase junk-stocks at absurd prices. They're scared to death of missing out.

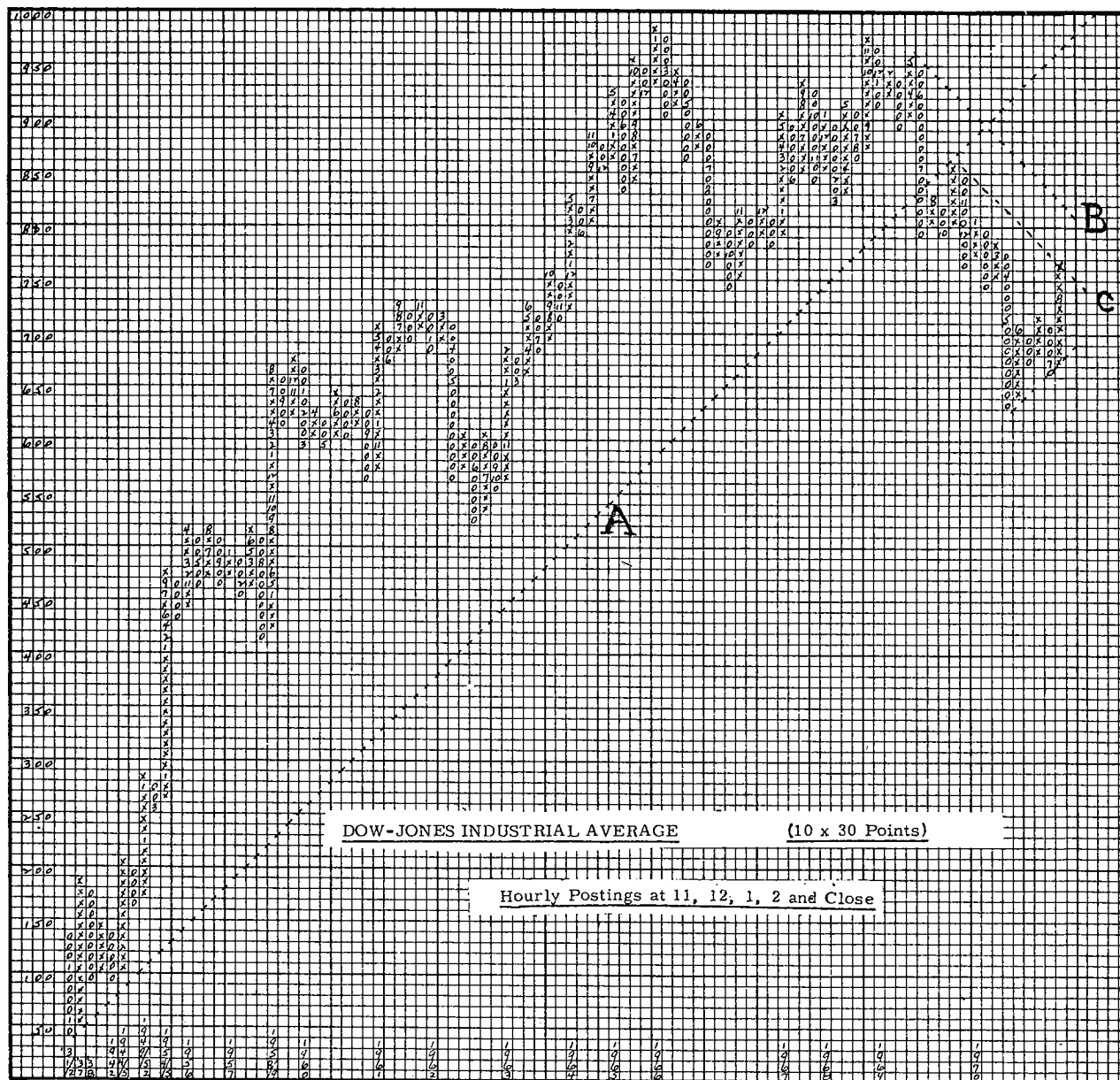
Another strange phenomenon exists. It is that the fear is usually conditioned by and based on the past. For instance, during most of a bear market "last year's" fear predominates. Right now, for instance, people are still afraid that they'll miss out on another bull market and a return to the highs. Most people aren't really afraid that if they buy here they'll ride the Dow down to 350 or 400. They're afraid of losing out on a "new bull market" or afraid that they'll miss their chance of getting even with last year's losses. That particular greedy fear will change as the bear market progresses. Ultimately, as the market heads down again and breaks to new lows, people will fear that they've been "taken", cheated by Wall Street and Washington. Then near the final bottom they'll fear that "there is no bottom," that the Dow is going to zero or out of existence.

Then, when a new bull market starts the public will be afraid that the market is crazy, that times will never get any better, that this is simply one more deception. All during the early stages of the new bull market "last year's" fear will prevail, and people will stay out because they know that it's only a matter of time before the Dow collapses towards zero again.

I firmly believe that if all fear was expressed (and therefore never stored up as a reservoir in people's minds) there would be no massive bull markets and disastrous bear markets. In other words, Wall Street would no longer be a place where people acted out their fears. The reasoned, wise, intelligent investors would simply purchase good stocks and collect dividends and wait. If everybody fell into that class, the upward movement would be over shortly, because no one would overbid, no one would chase stocks, no one would heat up the economy for fear of losing an election or for fear that he had to make a million dollars by age 40 or face total failure.

In short, I'm saying that fear plays a tremendous part in men's minds, in the affairs of the world and in the stock market. The giant swings of a bull and a bear market have their origin in the swings between the two types of market fears, the fear of losing everything and the fear of losing out on everything.

Is there a lesson in all this? I think there is a valuable one. It is this: don't act out your secret fears in Wall Street. Great fortunes have been made in Wall Street by men who understood crowd fear-psychology and who were able to move against it, particularly at the extremes. Traders act against those fears by stepping in and buying a short-term oversold or selling an overbought market. Investors act against extremes of public fear by buying when the "end of the world is in sight," and selling when "you better buy now, buy anything now, because the Dow is going to 2000."



POINT & FIGURE: The accompanying chart, which appears periodically in these reports, is presented courtesy of Chartcraft, Larchmont, N.Y. 10538. This is a 10-point, 30-point reversal chart, which means that each box represents 10 points on the Dow and only rallies or declines of a full 30 points are entered on the chart. One of the outstanding uses of P & F charts is that it presents a great deal of movement in the form of compression. In other words, here we see all the 30-point rallies and declines in the Dow Industrials since 1932 on a single small chart. P & F charts also are excellent for trendline purposes, and I have used the Chartcraft method of drawing trendlines at a 45 degree angle in interpreting this particular chart.

I have drawn three trendlines on this chart. The first, marked A, extends upward from the 1932 bottom of 40 on the Dow. This great trendline held for 37 years, from 1932 to 1969. Letters during 1968 and '69 drew repeated attention to this trendline, and when it was finally penetrated in July, 1969 (it was broken when the Dow touched 830), I issued the warning (Letter 435, August 6, 1970). Following the penetration of trendline A, the Dow dropped another 200 points to the 631.16 closing low of May 26, 1970.

Page 6 Trendline B represents an important descending or bearish trendline, and this has been drawn off the May, 1969 peak of 968.85. On the chart the Dow (if it continues to rise) would intersect trendline B at 830. I would expect trendline B to offer important resistance to any continuation of the current rally. Trendline B assumes particular importance since it is the "highest" bearish trendline which can be drawn in the bear market so far.

A lower and less significant trendline is the one marked C. This has been drawn off the 963.05 peak of November 10, 1969. As of last week the C trendline had been touched but not penetrated. It would require an hourly or closing figure of 780 to better trendline C.

If trendline C is bettered, the Dow would be in a position to test trendline B at 830. Time will tell whether the bear market rally can gather enough steam to attack the major trendline B on the chart.

NEW BOOKLET: I just read a book entitled "Swiss Bank Accounts and Financial Survival in Inflation and Devaluation." The book was written by Albert F. Gibson, a financial consultant from Massachusetts. I found this paper-bound 92-page booklet of great interest. In fact, it contains one of the most concise, usable, practical explanations of the Swiss Banks, the problems connected with placing accounts there, and the reasons for placing accounts there that I have seen. The subjects of inflation and devaluation are discussed very intelligently. Mr. Gibson takes a quite jaundiced view of the monetary outlook, and whether you agree with him or not, the information is here in very practical form.

I have agreed to handle this booklet for my subscribers, and those interested may send a check for \$7.50 payable to Dow Theory Letters. I might add that Mr. Gibson states that this book has been edited by top officials of two Swiss banks (for accuracy), and judging by the style and subtle points put forth in this volume, I certainly believe it.

GYRATIONS: In Letter 450 I included a chart of Natomas (then 54), and I explained why, despite the fact that the stock was down from 130 in 1969, it appeared to be under distribution and heading lower. As matters turned out, Natomas continued to drop to the 1970 low of 13 1/8. This represented a further loss of 75% from the depressed price of 54. The entire drop in Natomas from the 1969 peak of 130 to the 1970 low of 13 represented a loss of 90% of its value.

I include two charts, a monthly showing the Natomas picture since 1963 (courtesy of Horsey, Salisbury, Md. 21801) and a weekly showing a more detailed recent picture (courtesy of Quote Digest, 403 N. Main, Wichita, Kansas 67202). Two important technical factors bear on the Natomas price performance. The first is that when a stock drops drastically as NOM has, it is entitled to a drastic upside correction. Such corrections frequently recover half the losses in a matter of weeks or a few months. The halfway recovery mark for NOM is 71, and NOM since its low of 13 has moved just under its halfway recovery level. The greatest part of this huge rebound came about in a period of four weeks (see weekly chart).

If you will study the weekly chart you will also notice that the short interest in NOM is plotted in the form of little circles connected by a dashed line. The latest short interest figures practically go off the top of the chart (just above the Co of Natomas Co as printed on the chart). This means that there has been an obvious rush to cover shorts in NOM. Note that the short interest dropped rapidly as NOM collapsed. Then as the stock hit its low and worked up to the little consolidation pattern in the 28-30 area, the shorts piled in again. When the stock would not break and the general market moved higher, the shorts must have panicked. The result was the move from 30 to 68. Thus NOM has performed in classic bear market fashion. First it ruined the longs, then it ruined the shorts. I would guess that before the next year is away, the longs in NOM will have another chance at major losses.

LATE NOTES: The market often does what is least expected by the majority. It occurs to me that one of the oldest adages in the public's mind is "Never sell on strike news." With GM, the world's largest manufacturing company, on strike September 14, the old adage will be tested. It occurs to me that under the guise of "Never sell on strike news," this bear market rally could well be over. The peak of the rally was touched on September 8 for Industrials at 773.14 on the closing. The Transportation Index subsequently pushed high, hitting their most recent peak of 140.02 on September 11. The rise was not confirmed by Industrials. The test of my "hunch" is on.

NATOMAS COMPANY

